**Nos. 97-826, 97-829, 97-830, 97-831, 97-1075, 97-1087, 97-1099, and 97-1141**

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1997

GTE MIDWEST INCORPORATED,
*Cross-Petitioner,*

v.

FEDERAL COMMUNICATIONS COMMISSION AND THE UNITED STATES OF AMERICA,
*Cross-Respondents.*

**On Writs of Certiorari to the United States Court of Appeals for the Eighth Circuit**

## REPLY BRIEF FOR CROSS-PETITIONER GTE MIDWEST INCORPORATED


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July 17, 1998

## RULE 29.6 STATEMENT

Pursuant to Supreme Court Rule 29.6, GTE Midwest Incorporated hereby incorporates by reference the statement made in its opening brief.

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## INTRODUCTION[1]

GTE's opening brief demonstrated that the FCC's quadruple-barreled expansion of the duty to provide unbundled network elements ignores the terms of the Act and upsets the balance Congress achieved between competing objectives. In response, the FCC and its allies focus primarily on two tactics.

First, the FCC attempts to mischaracterize challenges to its unbundling rules as a "variety of policy contentions" unrelated to the text. FCC Reply 21. That is an obvious strawman. GTE's arguments are grounded firmly in the terms of the Act.

Specifically, with respect to the FCC's attempt to expand the definition of "network elements" to all aspects of an incumbent's business, the text limits network elements to "facilit[ies] and equipment" (including their "features") "used" in providing telecommunications service. 47 U.S.C. § 153(29). It is hardly a "policy contention" to point out that this language limits network elements to physical pieces of equipment in an incumbent's call-delivery network.

Similarly, with respect to *which* network elements should be unbundled, it is not a policy contention to show that the FCC misinterpreted the phrase in § 251(c)(3) governing *where* network elements must be available for interconnection ("at any technically feasible point") to create an erroneous presumption concerning *which* elements must be unbundled — namely, any element that it is technically feasible to unbundle. Nor is it a policy argument to demonstrate that, to conform the rest of the statute to its misreading of § 251(c)(3), the FCC eviscerated the standards of § 251(d)(2) that govern what network elements should be made available.

Likewise, the argument that the FCC erred in allowing entrants to engage in "sham unbundling" — purchasing all the elements needed to provide completed service in lieu of

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[1] In lieu of filing their own reply brief on the subjects addressed here, the Mid-Sized Local Exchange Carriers, Cross-Petitioners in No. 97-1141, have authorized GTE to state that they adopt the arguments in this brief.

purchasing service according to the statutory resale method — is again rooted in the text. Section 251(c)(3) provides new entrants "access" to "unbundled" "elements" of the network at any "technically feasible point." Those terms describe leasing *pieces* of the network; they do not reasonably extend to purchasing *complete* service — especially at prices different from the prices set by the Act for the same service.[2] The FCC's approach undermines the structure of the Act by creating a second, extra-statutory route for resale that evades the restrictions on resold services. The result of these distortions of the text, as we have explained, is a rampant opportunity for arbitrage that will undermine universal service.

More generally, reading the Act as a whole (rather than parsing individual terms in isolation), and evaluating the cumulative effect of the FCC's expansions of the unbundling duty, does not involve an appeal to free-floating policy. Even under the first step of *Chevron* analysis, considering the overall structure of an act of Congress to ensure that the construction of different sections will create a functioning whole (and to ensure that a misreading of an individual term will not undermine complementary parts of the statutory plan) is an integral part of a *textual* approach to statutory interpretation.[3]

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[2] This reply brief is limited to the issues raised in our cross-petition in No. 97-1087 and thus does not revisit specific arguments relating to the FCC's fourth step in expanding the unbundling duty — namely the requirement in Rule 315(b) that incumbents provide pre-assembled combinations of network elements. For the reasons stated in our opening brief, that rule, which is an integral part of the conversion of elements into "another way to resell," also violates the Act. *See* GTE Br. 65-71.

[3] *See, e.g., Sullivan v. Everhart*, 494 U.S. 83, 89 (1990) (on first step of *Chevron* analysis, court must determine meaning of statute by examining both "the particular statutory language at issue, as well as the language and design of the statute as a whole"); *Dole v. United Steelworkers*, 494 U.S. 26, 36 (1990) (evaluating agency rule in light of "consideration of the object and structure of the Act as a whole").

Second, unable to deny the plain effect of its four-part expansion of the unbundling duty, the FCC attempts to relabel bad as good. The FCC nowhere denies that its rules will promote precisely the arbitrage we have described. By allowing entrants to buy *all* the elements needed to provide finished service (indeed, by allowing entrants to purchase them as a pre-assembled platform at no extra charge), the FCC has converted network elements, as AT&T's president has explained, into "[a]nother way to resell." J.A. 255. This extra-statutory avenue for reselling service, however, evades the restrictions Congress imposed on resale. *See* §§ 251(c)(4), 252(d)(3). In particular, while Congress specified that an entrant reselling a service would pay a wholesale rate based on the incumbent's own retail rate, *see* § 252(d)(3) — a rate that would thus reflect universal service subsidies in retail rates — an entrant exploiting the FCC's unbundling rules can purchase finished service at a price that excludes universal service costs. The entrant is thus guaranteed that, while doing nothing but reselling an incumbent's service, it will be able to undercut retail rates for business customers whose rates have been set above cost to support universal service.

Unable to deny these results, the FCC resorts to Orwellian relabeling, claiming that the regulatory arbitrage promoted by its rules "is [merely] another name for . . . rational, cost-based competition." FCC Br. 21. But what the FCC's rules set in motion is, by definition, arbitrage: the FCC allows entrants to game two regulatory systems to buy service at one price, add nothing whatsoever, and turn around and sell at a higher price while undercutting state-regulated rates.

It is not "*real* competition," MCI Reply 5 (emphasis in original), moreover, to allow a competitor to purchase every last element of the incumbent's business at the prices that supposedly would prevail for a hypothetical, most-efficient network in a perfectly competitive market. Declaring by bureaucratic edict that the incumbent must sell its services to

its competitors at the price a government regulator believes would be established by perfect competition is not allowing competition to work (which is what Congress required); rather it is *bypassing* competition by attempting to set *in advance* the prices that a perfectly competitive (and perfectly nonexistent) market would produce.

By requiring an incumbent to sell its service at those prices to *competitors*, moreover, the FCC merely allows competitors to pocket most of the difference between current retail rates and its hypothetical, most-efficient price — thus depriving customers of the benefits of the process of competition. Worse still, since current retail rates reflect the costs of subsidizing universal service, the impact of the FCC's approach is to allow entrants such as AT&T and MCI to pocket the amounts that currently support affordable rates. Nothing about this system of arbitrage can remotely be equated with "real competition."

## ARGUMENT

### I. THE FCC ERRED BY RULING THAT ENTRANTS COULD PROVIDE SERVICE USING *SOLELY* NETWORK ELEMENTS.

Section 251(c)(3) provides potential entrants a method for purchasing discrete pieces or "elements" of the incumbent's network and for obtaining access to them "at any technically feasible point." The terms of the section make plain that Congress contemplated an incumbent offering entrants discrete pieces of its network and allowing an entrant to interconnect its facilities with these pieces at any of various points. The section thus provides a method of entry for carriers that have some facilities of their own.

For entrants who wanted to rely solely on the incumbent's network, Congress established a distinct method of purchasing finished service at wholesale rates for resale, *see* § 251(c)(4), and specified that the wholesale rate would be pegged to the incumbent's own (state-regulated) retail rate. *See* § 252(d)(3).

By allowing an entrant to purchase *all* of the parts of the network needed to provide service so that elements could be used — as AT&T's president put it — to "create local service," J.A. 256, the FCC impermissibly converted unbundled elements into another method for obtaining finished service and provided entrants a means for evading the limitations Congress imposed on resale.

The primary defense of the FCC's approach seems to be that Congress failed to explain in detail in § 251(c)(3) that converting the statutory method for buying discrete "elements" into an avenue for obtaining everything needed to resell local service — thus transforming it into "another way to resell" — would disrupt the separate system for resale that Congress explicitly created in § 251(c)(4). But there was no need for such an extraordinary caution. The ordinary presumption is that "[w]hen a statute limits a thing to be done in a particular mode, it includes the negative of any other mode." *Botany Worsted Mills v. United States*, 278 U.S. 282, 289 (1929). Section 251(c)(4) provides the method for obtaining finished service, and there can be no basis for twisting § 251(c)(3) into a redundant means of obtaining the same thing.[4]

The FCC and its allies do not advance analysis by repeating the mantra that there should be no restraint on network elements because Congress created several entry vehicles to give entrants a "range of opportunities." AT&T Reply 23. The very question is what sort of opportunity each distinct entry vehicle was intended to provide. Contrary to the

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[4] The FCC also strains to find support in the fact that § 251(c)(2), addressing interconnection, expressly refers to the entrant's "facilities and equipment," while § 251(c)(3) lacks a similar reference. *See* FCC Reply 27. That is hardly a basis for distorting the import of § 251(c)(3). Section 251(c)(2) also provides for "interconnection," and while § 251(c)(3) nowhere repeats that express requirement, the FCC found no difficulty in concluding that the section included an obligation to "provide a connection to a network element" independent of § 251(c)(2). J.A. 541 (¶ 269).

FCC's efforts at distortion, our arguments have nothing to do with imposing "artificial" limits on the use of unbundling to limit its utility as a means of entry, but rather with ensuring that each mode of promoting entry is used only as Congress specified in the Act.

Underlying the refrain about "multiple routes of entry" is the implicit assumption that Congress created multiple routes for obtaining effectively the same thing and established different pricing standards for these routes. That is utterly illogical. Congress explicitly addressed the method by which entrants could obtain service for resale in § 251(c)(4) and established a wholesale pricing standard to apply to such service. *See* § 252(d)(3). The FCC's efforts to expand a *different* provision of the Act dealing with access to pieces of the network into "another way to resell" — and at a different price to boot — turns statutory construction on its head.

Nor can the FCC defend its refusal to enforce the distinction between resale and purchasing discrete pieces of the network by claiming that it would be too hard to administer any requirement that purchasers of elements have at least some facilities of their own. FCC Reply 27-28. Such a rule no doubt would require the FCC to exercise discretion in drawing lines to preserve the structure of the Act Congress intended, but that is an agency's role. Where the FCC has wanted to extend its regulatory power, moreover — such as in the realm of setting prices — it has never balked at the difficulty of the task at hand.

Indeed, the FCC's confidence in its price-setting ability is particularly ironic here. The FCC claims that enforcing any facilities-ownership requirement will require the agency to force the use of alternative facilities, and thus that it would interfere with pure "market forces" guiding decisions about deploying facilities. *See* FCC Reply 22, 33. But by dictating the prices for network elements, government regulators are controlling incentives for deploying facilities just as surely as

they would be by requiring purchasers of elements to have some facilities of their own. As the FCC occasionally acknowledges, *see id.* 34, 35, it can pretend that its rules leave decisions up to the "market" only by assuming that prices for elements have been set perfectly at market levels, and that regulated rates will continue to mimic perfectly the prices that would be set in a dynamic market — a far-fetched proposition at best.[5] Enforcing a reasonable ownership rule thus would not fundamentally alter the agency's role at all. In short, regulation already controls incentives for deploying facilities, and an agency with such unbounded confidence in its ability to set rates perfectly could surely devise a reasonable rule to ensure that purchasing elements does not become an end-run around the Act's resale provisions.

Moving beyond the basic textual difficulties it encounters in transforming access to elements into an extra-statutory method for obtaining finished service, the FCC prefers to defend its rules at a higher level of generality. Thus, it makes a series of arguments intended to minimize the arbitrage that its rules promote None of these efforts can reconcile the FCC's approach to unbundling with the terms of the Act.

### 1. The Arbitrage Fostered by the FCC's Unbundling Rules Is Not "Real Competition."

The FCC's boldest maneuver is its effort to claim that the arbitrage promoted by its rules is not arbitrage at all, but rather the "rational, cost-based competition" that Congress intended to promote. FCC Reply 21. That is nonsense. Under the FCC's rules, an entrant can buy all the elements needed to "create local service" at rates that exclude any of the costs of supporting universal service. Then, without adding any facilities of its own or providing any inputs, it can secure a

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[5] One of the guiding assumptions of a de-regulatory statute like the Act, after all, is that regulation cannot perfectly mimic the market and thus that consumers will benefit from the actual process of competition.

guaranteed profit by turning around and reselling the incumbent's own service at rates below the above-cost rates state regulators have set (primarily for businesses) to support universal service.

To suggest that this quick-turnaround, buy-and-sell approach to repackaging the incumbent's own service is the "*real* competition," MCI Reply 5 (emphasis in original), that is the goal of the Act is absurd. An entrant exploiting the price differential between network element rates and the above-cost retail rates that support universal service does not produce any efficiencies or provide the benefits of innovation that Congress sought to foster through competition. *Cf.* H.R. Conf. Rep. No. 104-458, at 113 (1996) (Act seeks to "accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services").

Indeed, to the extent that such an arbitrageur might bring some consumers even the short-term benefit of lower prices, that results not from any added efficiency, but simply from the fact that the FCC allows the entrant to play two different regulatory systems off one another so as to buy an incumbent's service at one regulated price and to sell it by undercutting higher, regulated retail rates. The lower price comes from the entrant's ability to avoid the real costs of universal service built disproportionately into some customers' retail rates. This is not an "efficiency-inducing process," FCC Reply 30; it is the essence of arbitrage.[6]

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[6] Even the former Chairman of the FCC who presided over the creation of the First Report and Order has rejected the idea that the sham-unbundling approach fosters real competition. *See* Telecommunications Policy Open Meeting, transcript at 235 (Ill. Comm. Comm'n, July 14, 1998) (testimony of Reed Hundt) ("[R]eal competition, competition that brings investment and innovation, that ultimately permits deregulation, that has to be essentially facility based. I think all versions of resale are transitional techniques. The UNE platform is a version of resale.").

The FCC's effort to pass off this regulatory gamesmanship as genuine "competition," moreover, speaks volumes about the vision driving the FCC's approach to the Act. The FCC has made the classic error of conflating the proliferation of the number of "competitors" in the market with the advancement of competition. By providing an easy route for entrants to use the incumbent's own network to provide service at rates that are guaranteed to undercut current retail prices, the agency may succeed in subsidizing entry by a number of firms piggy-backing on the incumbent's network. But by stifling incentives for entrants to deploy new technologies of their own, it will inhibit the competitive process the Act was designed to foster.[7]

More fundamentally, the FCC and its allies demonstrate that their approach to expanding the unbundling duty is rooted in the belief that facilities-based competition is not a realistic possibility. AT&T makes this premise clearest as it asserts that the Act in no way rejects the assumption that local networks are a natural monopoly. *See* AT&T Reply 28 & n.11. Such an assumption necessarily leads to a very different view of the type of competition that can be fostered under the Act. Under AT&T's view, it would be irrational for competitors to develop rival networks. And not surprisingly, the FCC's approach to unbundling tracks this assumption perfectly. It is custom-tailored to produce a system in which there is only *one* network, effectively nationalized and sold off to so-called "competitors" at regulated rates so that they can provide carbon-copy services over the same facilities. That is plainly not the vision of robust competition that Congress had in mind.

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[7] *Cf.* Hon. Stephen G. Breyer, *Antitrust, Deregulation, and the Newly Liberated Marketplace*, 75 Calif. L. Rev. 1005, 1018 (1987) (explaining the risk that regulators "will protect competitors instead of protecting competition" and that the "consequence of misdirect[ed] protection is to threaten to deprive the consumer of the very benefits deregulation seeks").

### 2. The FCC's Extra-Statutory Creation of "Another Way to Resell" Promotes Arbitrage and Undermines the Restrictions Congress Established to Govern Resold Service.

The FCC and its allies next resort to a series of quibbles purportedly intended to downplay the arbitrage the FCC has opened up or to show that it will not systematically favor network elements in all scenarios. These claims are either misleading or irrelevant, and they provide no basis for reconciling the FCC's approach with the text of the Act.

To start, the FCC acts as if it can score a decisive point by explaining that a purchaser of elements does not receive the *exact* equivalent of service for resale. FCC Reply 38 (element purchaser can use the incumbent's facilities to provide services in different packages, for example, and can offer exchange access). But the basic end-run the FCC has created around the Act's resale provisions in no way depends on the capabilities offered to a purchaser of elements being limited in every detail to match those secured by a statutory reseller. Rather, the problem arises because the FCC has converted an avenue for buying "elements" into a method for "creat[ing] local service," J.A. 256, and thus has offered, in all functional respects, "[a]nother way to resell," J.A. 255.

In any event, the differences the FCC highlights serve only to show that an entrant exploiting the FCC's unbundling rules to "create local service" actually receives *more* than under the statutory resale route. But these facts only exacerbate the magnitude of the arbitrage opportunity by showing that a purchaser of elements gets a souped-up version of finished service — and still gets it all for a *lower price*. The FCC cannot logically *defend* its rules by pointing out that it has found a way to provide an even *more* outrageous arbitrage option than it would have provided by recreating an exact equivalent to wholesale service.

Next, the FCC and its allies proclaim that the FCC's reading must be permissible because it will not cause resale to fall *wholly* into disuse. This point, too, is irrelevant. What MCI would like to paint as the "key premise" of our argument — namely that "resale will *always* be more expensive than relying exclusively on network elements," MCI Reply 14 (emphasis added) — is not a premise of our argument at all. It is trivially true that for some customers — those who currently enjoy below-cost, subsidized rates — resale will remain the preferred method of entry. The entire point of the arbitrage problem is that there are different sets of customers who enjoy very different retail rates. The focus of arbitrage will be on customers at the *other* end of the spectrum — business customers whose retail rates have been set high to support universal service. Thus, the mere fact that the FCC's rules will not make resale *entirely* a dead letter in no way rescues the FCC's approach. If anything, by highlighting that the FCC has relegated statutory resale to the role of serving only one limited set of customers, this point again re-emphasizes that the FCC has devised an end-run around resale for the highest-profit segments of the market.

Next, the FCC and its allies claim that purchasers of network elements will not really be guaranteed easy profits because they face different risks from statutory resellers — in particular, the risk that they might not be able to cover the fixed cost of elements. *See, e.g.*, FCC Reply 39. Again, such claims incorporate a number of misleading assumptions. To start, the only elements that an entrant must purchase at a flat rate are the loop, network interface device (NID), and the port. Other elements have been priced on a usage-sensitive basis, and thus an entrant has no risk of an excess, up-front investment. And as for these flat-rated elements, comparisons to *residential* rates again distort the picture. *See* FCC Reply 39 n.25; MCI Reply 14 & n.5. Retail *business* rates typically exceed the basic cost of elements by a wide margin. For example, in North Carolina's Research Triangle Park, the cost

of an unbundled loop, NID, and port from GTE is $20.41; far below the retail rate of $39.95.[8] A purchaser of elements thus starts out with a hefty guaranteed profit.

As a result, there is nothing to the claims that entrants face a risk that they will not "stimulat[e]" sufficient demand for *new* services to cover costs. AT&T Reply 24. The purchaser of elements is not starting off with a loss to make up and does not need to "stimulate" demand to make a profit. Such complaints, moreover, create the impression that entrants like AT&T and MCI are gambling that they will not end up with high-cost customers that make little use of their telephones. That is misleading at best. Unlike incumbents, entrants are not required by state law to serve all customers in a given area; rather, they can target selected customers. And it is well known that the name of the game is high-volume, urban business customers — that is, customers who generate high revenues and low costs. Entrants have already established a pattern of targeting such customers,[9] and as AT&T's president has explained, their declared strategy is "to go into a high density, low [UNE] price zone," J.A. 257. Established interexchange carriers such as AT&T and MCI, moreover, already know which large business customers have high long

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[8] *See* North Carolina General Customer Tariff, GTE South Incorporated, 23d revised page 3 (filed Feb. 2, 1998) (retail rate); Recommended Arb. Order, *Petition of AT&T Communications of the Southern States, Inc. for Arbitration of Interconnection with GTE South, Inc.*, Docket No. P-140, Sub. 51, at 53, 60 (N.C.U.C. Feb. 4, 1997) (element rates).

[9] *See, e.g.*, M. Mills, *Bells Are Ringing on Wall St. for Local Phone Start-Ups*, Wash. Post, Oct. 1, 1997, at D-10 (entrants are "not after a mass market: Their target is business customers . . . ."); S. Berkelman, *Unleashed, AT&T Goes After Bells*, Newsday, Feb. 9, 1996 ("It's logical that bees follow honey and banks are robbed because that's where the money is, and our focus will be on concentrated markets in major cities with concentrations of business customers.") (quoting Robert Allen, Chairman of AT&T).

distance bills, and they can target those customers specifically.[10]

Any suggestion, moreover, that purchasers of elements face large up-front costs in developing new billing systems, *see, e.g.*, FCC Reply 40; MCI Reply 16, is baseless. One of the very arguments in this Court is an effort to protect current FCC rules that entrants believe will give them access to all the OSS necessary to handle billing and to "convert the recorded customer usage information into bills." AT&T Reply 44.

Finally, the FCC's supporters cannot immunize the FCC's rules by arguing that they are based on "findings" and "predictive judgments" showing that the agency's reading of the unbundling duty will not undermine the resale provisions. *See, e.g.*, MCI Reply 12-13; AT&T Reply 20. These supposed "findings" are just the quibbles about pricing and incentives dealt with above. At bottom, moreover, these assertions are nothing but a transparent effort to wrap up in the terminology of a factual "finding" a *legal* conclusion that the undisputed arbitrage promoted by the FCC does not evade the terms of the Act. But that question of law is for the Court to decide.

### 3. By Creating "Another Way To Resell" That Will Undermine Universal Service Funding, the FCC Violated the Terms of the Act.

The FCC and its allies cannot dispute that the arbitrage outlined above will undermine universal service funding. Indeed, they nowhere deny that, at least until an entirely new funding mechanism is in place under § 254, entrants taking

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[10] If by no other means, an entrant could ensure that its customers would meet a target volume of calls by selling local service in a package with a set number of minutes of long distance pre-paid. Unlike a statutory reseller, the purchaser of elements would not be prohibited from jointly marketing its long distance service with local service effectively resold from a local Bell company. *See* § 271(e). The FCC's version of unbundled elements provides an end-run around that restriction of the Act as well.

advantage of the FCC's approach to unbundling would be able to evade any contribution at all to universal service. Instead, they attempt, in part, to belittle this result as a mere "policy" concern. But that ignores the text of the Act. Congress specifically pegged the wholesale price for an incumbent's service to the retail rate — and thus ensured that it would reflect the costs of universal service subsidies. *See* § 252(d)(3). By creating another way to "create local service" through network elements sold at rates that (under the prevailing interpretation) *do not* reflect such subsidies, the FCC's rules evade the explicit protection built into the wholesale pricing term. As explained above, moreover, examining the FCC's approach to unbundling in light of the text and structure of the Act's resale provisions, and more generally in light of terms showing Congress's concern for preserving (rather than undermining) universal service, is not a foray into policy — it is part and parcel of proper construction of the Act.

Next, the FCC and its allies try to brush aside the free ride on universal service that the FCC is offering entrants by claiming that these are "interim concerns" properly resolved by the reforms required by § 254, including a new, explicit funding system. But the "interim" period these parties would like the Court to overlook is the critical transition period that will give entrants like AT&T and MCI a chance to cash in on a unique exemption from universal service burdens to cream-skim billions of dollars worth of incumbents' highest-value customers. AT&T's explanations of how entrants *will* contribute to universal service *once* § 254 has been implemented, AT&T Reply 29, are irrelevant. That system does not yet exist. Rather, the FCC has determined that there will be no explicit funding to reform universal service until at least 1999. In re Federal State Joint Board on Universal Service, CC Docket No. 96-45, ¶ 26 (May 8, 1997).

Indeed, for that reason it is supremely ironic that the FCC would now claim that the "proper way" to deal with the threat

that its unbundling rules undeniably pose to universal service is to "ensure timely implementation of the universal service reforms ordered in Section 254." FCC Reply 31. Ignoring the fifteen-month timetable set by Congress, *see* § 254(a), the FCC has postponed explicit funding under § 254 until 1999 and is now fighting before the Fifth Circuit to protect its delays, insisting that the "explicit and sufficient" funding system demanded by the Act is not an "immediate requirement" at all, but rather is merely an "eventual goal." *See* Brief for the FCC 49, *in Texas Office of Pub. Utility Counsel v. FCC*, Nos. 97-60421, *et al.* (5th Cir.).[11] Even on its face, therefore, the suggestion that unbundling arbitrage will be taken care of by swift action on § 254 cannot be taken seriously.

In any event, efforts to reduce the arbitrage here to an interim quibble about the timing of universal service reform are misplaced. First, as explained above, the root problem in the FCC's approach to converting access to "elements" into "another way to resell" is that it defies a basic limitation in the text of the Act linking the price for wholesale service to retail rates. *See* § 252(d)(3). That limitation applies at all times, regardless of the state of universal service reform. Creating a second method for purchasing service that will avoid that pricing standard flatly distorts the Act.

Second, at a more practical level, the suggestion that § 254 will remove any opportunity to game the system is simply incorrect. To be sure, the discrepancy between the wholesale rate set by the Act and the price for service recreated through "unbundled" elements is starkest when one focuses on implicit subsidies in retail rates. But even if implicit subsidies are removed, the FCC's rules will still offer entrants two routes for obtaining finished service at prices determined under

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[11] In fact, the FCC is now considering proposals to postpone explicit funding even further. *See* In re En Banc Hearing, tr. at 26 (FCC June 8, 1998) (available at http://www.fcc.gov/enbanc/060898/eb060898.html).

different statutory sections. There is no guarantee that the bottom-up approach of setting cost-based rates for elements will result in the same price as the top-down approach of applying a discount to retail rates — the method that Congress demanded in § 252(d)(3) for wholesale service. To the contrary, the prevailing approach under § 252(d)(1)'s cost-based standard (using long-run incremental costs of hypothetical networks) systematically excludes a variety of actual costs included in incumbents' retail rates; thus, it would necessarily yield a different price from the wholesale rate. The FCC's extra-textual method for using elements as "another way to resell" thus will always provide entrants some opportunity for gaming the system to receive a substitute for wholesale service at a price different from the one specified by the Act.

## II. THE FCC IMPROPERLY EXPANDED THE DEFINITION OF NETWORK ELEMENTS.

Remarkably, the FCC does not spend a single sentence in its brief defending the construction of the statutory definition of network elements that is at the heart of this part of the case. Below, the FCC insisted that by referring to a "facility or equipment" used in providing "telecommunications *service*," § 153(29) (emphasis added), Congress radically expanded "network elements" far beyond the network itself to include any asset that an incumbent uses in "offering" telecommunications to the public. Indeed, the agency convinced the Eighth Circuit to adopt this reading, making the breadth of the "overall commercial offering of telecommunications" the key factor in determining the scope of network elements. Pet. App. 42a-43a. *See also id.* (OSS are network elements because they "constitute features, functions, and capabilities that are provided through the use of software and hardware that is used *in the commercial offering of telecommunication services to the public*") (emphasis added).

As we explained before, that extravagant gloss removes any textual constraint on what is deemed a "network element."

Everything that a LEC owns is used in some way to "offer" service. No doubt recognizing the indefensible overbreadth of that rationale, the FCC now abandons it, relegating it to a parenthetical in a footnote, *see* FCC Reply 47 n.31, and leaves any further defense of that theory to its allies. *See* AT&T Reply 47. As a result, the FCC nowhere provides any limiting principle to constrain the approach to defining network elements that the decision below has enshrined as law.[12]

An illustration readily shows the limitless nature of the FCC's distorted definition. If an incumbent used telemarketers to offer subscribers new services, such as Caller ID, an entrant could demand the right to "unbundle" and rent four or five telemarketers to perform the same functions on its behalf. The telemarketers are, after all, plainly used in "offering" telecommunications service to the public. Under the FCC's definition, there could be no logical reason for refusing to treat them, like operators, *see infra* pp. 19-20, as network elements.

Nor do the FCC's allies provide any principle to limit what might be deemed a network element. Instead, in response to the charge that the FCC would require incumbents to offer entrants effectively every back-office system so that entrants can manage their businesses "just as efficiently as incumbents," they confirm that this is "precisely" what they want. MCI Reply 24. But by mandating access to the "facilit[ies] or equipment" of the network, Congress in no way required incumbents to turn over additional systems entirely outside the network that they use to run their businesses. *See infra* pp. 20-

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[12] Nor does the FCC attempt to reconcile its countertextual gloss on the term "facilities" with the opposite approach the agency itself took in another section of the same Act. As noted before, *see* GTE Br. 56 n.22, under § 214(e), the FCC has determined that "facilities" used to "offer" telecommunications services are limited to "physical components of the telecommunications network that are used in the transmission or routing" of calls. In re Federal-State Joint Board on Universal Service, CC Docket No. 96-45, ¶ 151 (May 8, 1997).

22. Requiring incumbents to surrender such expertise eliminates incentives for entrants to develop systems of their own and short-circuits the innovation the Act was designed to foster.

Even a cursory examination of the text shows that the FCC's approach to defining elements has nothing to do with the definition set by Congress. By limiting a "network element" to a "facility or equipment" (including its "features, functions, and capabilities") "used in the provision of a telecommunications service," § 153(29), Congress rooted "network elements" in the physical facilities of the local exchange. Indeed, Congress made clear that the equipment it was designating consisted of components of the call-routing network as it went on to explain that the "features" of such equipment that should also be made available are those "used in the transmission, routing, or other provision of a telecommunications service." *Id.* Despite the FCC's protests, there is no logical or textual basis for reading this reference to "other provision" of service as an engine for expanding "network elements" beyond the physical network. That general term rounds out a list of specific steps in the delivery of a call and should be read to refer to similar call-delivery functions.

Parsing the text thus confirms the result demanded by common sense. Congress did not transform the term "network element" into obscure jargon designating a limitless array of capacities an incumbent uses to run its business. Rather, the term means physical "elements" or pieces of the network — along with features and functions embedded in those facilities.

By concocting a concept of network elements that has no bounds, the FCC abandoned the task of determining what facilities actually fit the definition enacted by Congress. In particular, the agency erred by requiring unbundling of operator services and directory assistance and by treating all operational support systems (OSS) as network elements.

### 1. The FCC Erred By Treating Discrete Services As Network Elements.

Virtually the entire defense that the FCC and its allies can muster for the rules treating operator services and directory assistance as network elements is the repeated assertion that operator functions are "increasingly automated," FCC Reply 49, and thus that the FCC's rules will not *always* require the bizarre task of "unbundling" and renting out to competitors live operators. *See also* MCI Reply 25; AT&T Reply 49. But this half-hearted effort to blunt the jarring results of the FCC's rules simply papers over the basic conflict between unbundling operators and the terms of the Act. The Act limits network elements to a "facility or equipment" (or its "features") and cannot be stretched to include people (or the complex of tasks they perform). Whether operator services or directory assistance may in *some* instances be entirely automated is irrelevant. The FCC's approach to defining network elements treats an incumbent's personnel as the "elements" to be leased to an entrant and thus is flatly at odds with the text.

Similarly, the FCC cannot defend its rules with the facile claim that all network elements are controlled at some level by people and thus that "human involvement" cannot take operator services out of the ambit of network elements. FCC Reply 49. Providing "unbundled" operator services demands far more than the "human involvement" that may be needed to ensure, for example, that an unbundled loop is still up and functioning when an entrant orders it. The very "element" that the entrant is ordering, after all, is not a piece of equipment, but the service provided by the operators themselves. Indeed, in all relevant respects, leasing operators is indistinguishable from leasing the telemarketers described above. Neither can be reconciled with the text of the Act.

Finally, the FCC offers no plausible justification for treating distinct services (such as operator services) as network elements. As we noted before, Congress addressed "services"

and "network elements" in separate sections of the Act and even deleted any references to "services" from the definitions of network elements that had appeared in earlier drafts of the statute. *See* GTE Br. 57-58. The FCC's bald assertion that distinct services nevertheless should be treated as network elements ignores standard principles of construction. Where Congress has established distinct, defined terms such as finished "services" and "network elements" the use of one term necessarily implies the exclusion of the other. *See, e.g., O'Melveny & Meyers v. FDIC*, 512 U.S. 79, 86 (1994). Nor can the FCC salvage its approach to conflating services with network elements with the specter of incumbents evading unbundling by artificially labeling pieces of the network as separate services. *See* FCC Reply 48. The agency could easily prevent such patent evasions.

**2. The FCC Erred By Indiscriminately Treating OSS as Network Elements.**

As explained in our opening brief, the broad category of OSS includes a number of different systems used by an incumbent LEC in running its business. The FCC naturally tries to portray OSS as systems needed to "manipulat[e] network elements to provide services." FCC Reply 45. It is indisputable, however, that not every system included under the generalized heading of OSS performs such a function; rather, many such systems control entirely independent business functions such as managing billing or even scheduling the visits of repairmen. Indeed, even AT&T tacitly acknowledges that not all OSS play a role in operating the network. Instead, the most that AT&T can assert is that "[m]any of these systems" — not all — are "connected electronically to the facilities that route calls within the network." AT&T Reply 44-45. The rest of the systems grouped into the class of OSS are thus entirely *outside* the network.

By indiscriminately treating *all* OSS as network elements, the FCC failed even to undertake any inquiry to determine whether each system it was making available to entrants could actually fit within the definition of a network element — that is, a "facility or equipment" (or a feature of such a piece of equipment) that is used in the LEC's call-routing network.

In part, the FCC defends this broad-brush approach to OSS unbundling by focusing on half-truths. Thus, the FCC asserts that the second sentence of the statutory definition includes items such as "databases" and "information sufficient for billing and collection," § 153(29), that are examples of OSS. *See* FCC Reply 47; *see also* MCI Reply 24. The mere fact that Congress specifically designated *some* items that might be called OSS as network elements, however, does not remotely justify the FCC's decision to treat *every* system in the loose category of OSS as a network element.

Moreover, contrary to the FCC's assertions, *see* FCC Reply 47, by proposing that network elements should be limited — as the Act requires — to "facilit[ies] or equipment" in the call-routing network (including their "features, functions, and capabilities"), GTE has not offered a definition that would exclude any items actually enumerated in § 153(29). The "databases" and "information" mentioned in the section are plainly recorded and stored in computers that are part of the physical pieces of the call-routing network — not entirely separate systems that the LEC uses in administrative functions. Indeed, the Act lists such databases and information not as free-floating categories of network elements in their own right, but solely as examples of the "features, functions, and capabilities that are provided *by means of [a] facility or equipment*." § 153(29) (emphasis added).

Having established the trivial proposition that *some* OSS are included in the definition of network elements, the FCC and its supporters would like to gloss over the critical distinction between systems that are part of the network — such as the

databases in § 153(29) — and every separate software system used by a LEC in conducting other functions — for example, software used to transform information from network databases into bills. As AT&T candidly acknowledges, what it wants through access to OSS is not simply access to the "databases" or "information *sufficient* for billing and collection" that Congress included in the definition of network elements, § 153(29) (emphasis added). Rather, it wants the entire software system used "to *convert* the recorded customer usage information into bills." AT&T Reply 44 (emphasis added). By mandating access to data "sufficient" to create bills, however, Congress did not remotely require the broad access to software systems that AT&T would like.[13] By indiscriminately lumping into "network elements" anything that might be called a support system, however, the FCC never considered whether the terms of the Act were sufficient to grant access to the various systems it was providing to entrants.

Finally, the FCC and its allies assert that the FCC found that access to OSS should be required to ensure nondiscriminatory access to other network elements. *See, e.g.*, FCC Reply 46. But that is the purest makeweight. The FCC would render the specific terms of the definition limiting network elements utterly meaningless if it could grant access to every aspect of an incumbent's business on the theory that it was necessary for nondiscriminatory access to elements.

## III. THE FCC REFUSED EVEN TO CONSIDER THE STANDARD CONGRESS SET FOR DETERMINING WHAT ELEMENTS MUST BE UNBUNDLED.

The FCC does not even respond to the errors the cross-petitions have identified in its approach to the "necessary" and

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[13] Indeed, under the FCC's approach, it is hard to see what would stop AT&T from ordering the entire function of "billing" to be performed for it by the incumbent's personnel as yet another so-called "network element."

"impair" standards of § 251(d)(2). The section directs that, in determining which network elements should be made available, the FCC "shall consider" whether access to proprietary elements is "necessary" and whether failure to provide access to non-proprietary elements would "impair" an entrant's ability to provide service. § 251(d)(2). As we have explained, the FCC distorted those tests in two steps.

First, the agency misconstrued § 251(c)(3)'s command concerning *where* an incumbent must provide access to elements ("at any technically feasible point") as a command defining *what* had to be unbundled. The FCC thus created an extra-statutory presumption (since vacated, *see* Pet. App. 46a-47a) requiring unbundling of every element that could technically be unbundled. Next, when the FCC turned to the standards in § 251(d)(2) *limiting* access to elements, it perceived a tension between the section and its own blanket presumption favoring unbundling. Giving primacy to its own erroneous presumption, the FCC read § 251(d)(2) so as not to "significantly diminish the obligation imposed by section 251(c)(3)." J.A. 54. As a result, the FCC watered down the "necessary" and "impair" standards by refusing even to look at existing alternative facilities outside the incumbent's own network. The FCC thus distorted the standards enacted by Congress and evaluated entirely different tests.

Rather than addressing these undeniable errors, the FCC resorts to diversions, claiming that its dictionary definitions for "necessary" and "impair" were reasonable and stressing that Congress did not make those standards dispositive tests. *See, e.g.*, FCC Reply 42-44. Similarly, its supporters repeat that there was no need to consider the *theoretical* possibility of future alternative facilities. *See* MCI Reply 29-30.

GTE's challenge has nothing to do with these red herrings, and in particular does not turn on whether Congress made the § 251(d)(2) standards dispositive. The question is whether the FCC *considered* the standards Congress specified *at all*, or

whether, by refusing to consider alternatives outside the network, it fundamentally distorted the statutory criteria. When Congress limits an agency's discretion by defining a standard to be considered — even if it is not a dispositive test — the agency must at least evaluate the standard enacted into law, not a modified test of its own creation. *See Marsh v. Oregon Natural Resources Council*, 490 U.S. 360, 378 (1989) (agency must consider "the relevant factors"); *United States v. Markgraf*, 736 F.2d 1179, 1183 (7th Cir. 1984) ("Where Congress has provided express standards to guide an agency in its exercise of discretion, we will presume that Congress did not intend the agency to substitute its own standards for discretion."), *cert. dismissed*, 469 U.S. 1199 (1985).

On this point the FCC offers no defense. The statutory command is so straightforward — and the FCC's disregard for it so stark — that there is no justification for its approach. It defies plain English for the FCC to pretend that access to a particular element is "necessary" (or that its absence would "impair" ability to provide service) when an entrant can obtain comparable equipment from another source.

Despite AT&T's assertions, moreover, *see* AT&T Reply 43-44 & n.17, alternative facilities are not mere fantasies. As the Conference Report pointed out, the infrastructure that cable companies have already deployed provides a realistic basis for facilities-based competition. *See* H.R. Rep. 104-458, at 148. Indeed, AT&T itself is banking on the use of such facilities "to begin providing digital telephony and data services to consumers"[14] — that is the very basis for its recent proposed merger with TCI. By refusing even to consider when such facilities (or others) would provide an alternative to the incumbent's network, the FCC removed any restraint on access to elements that would encourage entrants to use alternatives in providing local service.

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[14] AT&T and TCI Joint Press Release, June 24, 1998.

Nor can the FCC be rescued with the claim that considering alternatives outside the network would be pointless because entrants would voluntarily choose alternatives if they were more efficient. *See* MCI Reply 30; AT&T Reply 43. If Congress had intended to leave it entirely up to entrants to determine when they would use elements from an incumbent's network and when they would use alternatives, Congress would not have enacted § 251(d)(2). Section 251(d)(2) contemplates that the FCC will exercise discretion in determining whether particular elements should be made available to entrants, and that it will do so after evaluating a standard set by Congress. By mandating this independent evaluation of *need*, Congress clearly intended to restrain access to elements to preserve incentives for entrants to use alternative facilities where possible. Only where entrants use alternative facilities (or deploy their own) will they begin to generate efficiencies and provide the genuine benefits of competition. Some restraint on access to elements was essential, for as has long been recognized in the antitrust context, when the government forces a company to "provide [a] facility and regulat[es] the price to competitive levels, then the [entrant's] incentive to build an alternative facility is destroyed altogether." 3A P. Areeda & H. Hovenkamp, *Antitrust Law* ¶ 771b, at 175 (1996).

By effectively leaving the choice between an incumbent's network and using comparable alternative facilities wholly in the hands of new entrants, the FCC abdicated the role Congress assigned it and defeated the purpose of § 251(d)(2).

## CONCLUSION

For the foregoing reasons, the Eighth Circuit's judgment upholding the FCC's rules (i) allowing entrants to provide service using *solely* network elements; (ii) expanding the definition of network elements; and (iii) refusing to consider alternative facilities outside an incumbent's network under the standards specified by § 251(d)(2) should be reversed.

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